

Accounting for Income Taxes Notes

Overview of Income Tax Accounting

Accounting for income taxes reconciles differences between **book income** (per US GAAP) and **taxable income** (per the Internal Revenue Code), ensuring accurate reporting of tax expenses and obligations. It is governed by **ASC 740** (US GAAP) and **IAS 12** (IFRS), focusing on recognizing current and deferred tax effects of transactions.

Purpose

- To report the tax effects of transactions in the same period as the transactions are recognized in financial statements.
- To account for temporary and permanent differences between book and taxable income.
- To provide transparent disclosures about tax assets, liabilities, and expenses.

Calculating Income

Income is calculated in two ways, leading to different tax obligations:

1. **Book Income (US GAAP):** Reflects income reported in financial statements, representing what the company “wants to pay” in taxes based on accounting standards.
2. **Taxable Income (Internal Revenue Code):** Determines the actual taxes owed to the government, based on tax laws.

Differences Between Book and Taxable Income

Differences between book and taxable income arise from:

1. **Temporary Differences:** Timing differences in when revenues or expenses are recognized for book vs. tax purposes, which reverse over time.
2. **Permanent Differences:** Items included in one income calculation but not the other, which do not reverse.

Temporary Differences

Temporary differences create **deferred tax assets (DTAs)** or **deferred tax liabilities (DTLs)** due to timing mismatches.

- **Deferred Tax Assets (DTAs):** Arise when book income is less than taxable income, resulting in prepaid taxes.
 - **Examples:**
 - Warranty expenses recognized for book purposes before tax purposes.
 - Net operating losses (NOLs) that can offset future taxable income.
 - Journal Entry:
 - Dr Deferred Tax Asset XXX
 - Cr Income Tax Benefit XXX

- **Deferred Tax Liabilities (DTLs):** Arise when book income exceeds taxable income, deferring tax payments.

- **Examples:**
 - Revenue recognized for book purposes before tax purposes (e.g., advance payments).
 - Accelerated depreciation for tax purposes (e.g., MACRS) vs. straight-line for book purposes.
- Journal Entry:
- Dr Income Tax Expense XXX
- Cr Deferred Tax Liability XXX

Permanent Differences

- Do not create DTAs or DTLs as they do not reverse.
- **Examples:**
 - Municipal bond interest (tax-exempt).
 - Non-deductible expenses (e.g., fines, entertainment costs).
 - Journal Entry (affects current tax expense only):
 - Dr Income Tax Expense XXX
 - Cr Income Taxes Payable XXX

Total Tax Expense

Total tax expense comprises two components:

1. **Current Tax Expense:** The amount payable to the government for the current period, based on taxable income.
2. Dr Income Tax Expense XXX
3. Cr Income Taxes Payable XXX
4. **Deferred Tax Expense or Benefit:** The change in DTA or DTL balances due to temporary differences during the period.

Calculating Deferred Tax Assets or Liabilities

- **Formula:** Temporary Difference × Enacted Tax Rate for the period the difference reverses.
- **Enacted Tax Rate:** The tax rate legally passed by the government for future periods.

Example: Deferred Tax Calculation

A company receives a \$50,000 advance deposit in Year 1, taxable at 25% in Year 1, but recognized as revenue for book purposes evenly over Years 2 (\$25,000, 24% tax rate) and 3 (\$25,000, 22% tax rate).

- **Year 1 Temporary Difference:** \$50,000 (taxable, not booked).

- **DTA Calculation:**

- Year 2: $\$25,000 \times 24\% = \$6,000$
- Year 3: $\$25,000 \times 22\% = \$5,500$
- Total DTA = $\$6,000 + \$5,500 = \$11,500$

- **Journal Entry:**

- Dr Deferred Tax Asset 11,500
- Cr Income Tax Benefit 11,500

Timing of Creation and Reversal

Temporary differences vary by creation and reversal periods:

1. **Single Creation, Single Reversal:**

- Multiply the current-year difference by the enacted tax rate for the reversal year.
- Example: A \$10,000 expense deductible for tax in Year 2 (25% rate) but booked in Year 1.
 - $\text{DTA} = \$10,000 \times 25\% = \$2,500$
- Dr Deferred Tax Asset 2,500
- Cr Income Tax Benefit 2,500

2. **Single Creation, Multiple Reversals:**

- Allocate the temporary difference to each reversal period and apply the respective enacted tax rates.
- **Example:** On December 31, 2024, Bora Bora Manufacturing Co. receives \$200,000 advance rent (\$100,000 per year for 2025 and 2026). The rent is taxable in 2024 at 25%, but booked in 2025 (24% tax rate) and 2026 (22% tax rate).
 - Temporary Difference: \$200,000
 - $\text{DTA} = (\$100,000 \times 24\%) + (\$100,000 \times 22\%) = \$24,000 + \$22,000 = \$46,000$
 - Journal Entry:
 - Dr Deferred Tax Asset 46,000
 - Cr Income Tax Benefit 46,000

3. **Multiple Creations, Multiple Reversals:** Complex calculations typically outside the CMA exam scope.

Tax Rate Changes

When the enacted tax rate changes, adjust DTAs/DTLs in the period the change is enacted, even if not yet effective.

- **Example:** A \$60,000 DTL from a \$200,000 temporary difference (30% tax rate) is adjusted when the rate for the next year increases to 35%.

- New DTL = $\$200,000 \times 35\% = \$70,000$
- Adjustment = $\$70,000 - \$60,000 = \$10,000$
- Journal Entry:
 - Dr Income Tax Expense 10,000
 - Cr Deferred Tax Liability 10,000

DTA Valuation Allowance

If it is more likely than not (>50% probability) that a DTA will not be realized due to insufficient future taxable income, establish a valuation allowance.

- **Journal Entry:**
- Dr Deferred Income Tax Expense XXX
- Cr Valuation Allowance for DTA XXX
- If related to a net operating loss (NOL):
- Dr Benefit Due to Loss Carryforward XXX
- Cr Valuation Allowance for DTA XXX

Net Operating Losses (NOLs)

- **Pre-2018 NOLs (US Tax Law):** Could be carried back 2 years or forward 20 years to offset taxable income.
- **Post-2017 NOLs:** No carryback allowed; carryforward is indefinite but limited to 80% of taxable income annually.
- **Loss Carryback:**
 - Dr Income Tax Refund Receivable XXX
 - Cr Income Tax Benefit from Loss Carryback XXX
- **Loss Carryforward:**
 - Dr Deferred Tax Asset XXX
 - Cr Income Tax Benefit XXX

Balance Sheet Presentation

- DTAs and DTLs are netted together for each tax jurisdiction, presented as a net DTA or DTL.
- Valuation allowances are reported as a reduction to DTAs.

Example Problem: Deferred Taxes in a Business Combination

Scenario: On January 1, 2025, Company A acquires Company B for \$4,000,000. The fair value of Company B's net identifiable assets is \$3,200,000, including a \$100,000 warranty liability (deductible

for tax purposes when paid) and a \$150,000 patent (tax basis \$0 due to different depreciation rules). The enacted tax rate is 25%. Calculate goodwill and record the acquisition, including deferred tax effects.

Solution:

1. Deferred Tax Effects:

- Warranty Liability:
 - Temporary Difference: \$100,000 (deductible when paid).
 - DTA = $\$100,000 \times 25\% = \$25,000$
- Patent:
 - Temporary Difference: \$150,000 (book value \$150,000, tax basis \$0).
 - DTL = $\$150,000 \times 25\% = \$37,500$
- Net Deferred Tax Effect: $\$25,000 \text{ (DTA)} - \$37,500 \text{ (DTL)} = \$12,500 \text{ net DTL}$
- Adjusted Net Identifiable Assets = $\$3,200,000 - \$12,500 = \$3,187,500$

2. Calculate Goodwill:

- Purchase Price: \$4,000,000
- Adjusted Net Identifiable Assets: \$3,187,500
- Goodwill = $\$4,000,000 - \$3,187,500 = \$812,500$

3. Journal Entry for Acquisition:

- | | |
|-------------------------------|-----------|
| 4. Dr Net Identifiable Assets | 3,200,000 |
| 5. Dr Goodwill | 812,500 |
| 6. Dr Deferred Tax Asset | 25,000 |
| 7. Cr Cash | 4,000,000 |
| 8. Cr Deferred Tax Liability | 37,500 |

Additional Notes

- **IFRS vs. US GAAP:**
 - IFRS (IAS 12) nets DTAs and DTLs only if they relate to the same tax authority and there is a right to offset. US GAAP requires netting within each jurisdiction.
 - IFRS does not present valuation allowances separately; they are netted against DTAs.
- **Tax Implications:** Permanent differences affect only current tax expense, while temporary differences impact both current and deferred tax expense.
- **Disclosures:** Companies must disclose DTA/DTL balances, valuation allowances, NOL carryforwards, and reconciliation of effective tax rates.

Best Practices

- Use enacted tax rates for accurate DTA/DTL calculations.
- Regularly assess the realizability of DTAs to determine the need for valuation allowances.
- Ensure compliance with ASC 740/IAS 12 for tax accounting and disclosures.